

Economic Newsletter, Vol. 5, Issue 2

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Economic Reform and Reconstruction Bosnia and Herzegovina

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1. Government Unveils new Poverty Reduction Strategy

Working in close collaboration with the World Bank, the Council of Ministers and the Entities have undertaken to develop a coordinated approach to reduce endemic poverty. Based on a World Bank format currently in use in over 40 other countries, the Poverty Reduction Strategy Paper draws on the empirical data acquired in the Living Standard Measurement Survey (LSMS), which found that around 19.1 percent of people in BiH receive incomes that fall below the poverty line of 1,50 KM per day. The sources of poverty are identified as a low level of economic activity and high unemployment, an inadequate social welfare system and abuse of human rights specifically with regard to displaced persons.

The general priorities of the PRSP are threefold: (1) to improve the business environment for domestic and foreign investors; (2) to fight corruption; and (3) to speed up

BiH's integration into the EU. Improving the business environment involves a number of steps aimed at: establishing a stable macroeconomic framework; structural changes including privatization of large companies, a strengthened supervisory role for the Central Bank, reform of both the health and pension funds and the labor market; and initiatives to boost foreign trade and reduce administrative barriers to investments. The fight against corruption is receiving considerable attention, centering on judicial reform and new legislation. Integration into the EU remains a preeminent theme and one of the most important priorities, with efforts to meet the Road Map requirements nearly complete. Other important sectors for the PRSP include agriculture, education, health, environment and information technology.

In an effort to engage the broad spectrum of society in the initiative, the Government has conducted over 120 consultations with the private sector, NGOs, foreign investors, trade unions, academicians, members of Parliament and donors. Specific topics of these consultations have included how to halt the exodus of young people from the country, development of the private sector, social security, human rights, the tax system and gender equality, in addition to the priority themes indicated above.

Next steps in the strategy are to initiate an extensive media campaign in July, finish work on sector studies in August, and then refine the PRSP for final adoption by entity and state institutions in December 2002/January 2003.

2.OHR/OECD Conference on Regulatory Governance

As a transition economy moving from a centrally planned to a market based system in accordance with EU standards, Bosnia and Herzegovina is having to create regulatory agencies in various sectors. The creation of such agencies requires knowledge of both economic and social objectives of regulation, the benefits of having regulatory agencies, the

need for financial and political independence, etc.

This was the subject of an OHR/OECD Conference on Regulatory Governance, held at the Holiday Inn on 19 April in Sarajevo. The Communications Regulatory Agency, the Banking Regulatory Agency and other independent market regulators are an integral and indispensable part of the transformation of the BiH economy, Deputy High Representative and Head of the OHR Economics Department Patrice Dreiski told the conference in his opening speech. Other speakers included Chairman of the Council of Ministers Dragan Mikerevic, and Deputy Minister for Foreign Trade and Economic Relations Jadranko Prlic.

Effective regulators are a prerequisite for attracting foreign investment and ensuring the success of privatization. Investors will not risk money in markets where regulations are elastic, or where different rules apply to different players. Regulation helps make markets work, by ensuring that natural monopolies deliver optimum prices and services to consumers and by ensuring that in strategic sectors such as utilities, a level playing field is established so as to allow companies to operate in fair competition.

On the independence and accountability of regulators, the job of policymakers is to set policy and they must do this for the market regulators. After that, they must let the regulators regulate. The regulator is accountable to consumers, to the taxpayer and to the government. With a clear mandate and clearly defined parameters of discretion, the regulator can maintain its independence and authority and at the same time respond efficiently to policy guidelines.

Establishing an efficient regulatory regime in BiH is a condition for closer European integration. As with all the other EU Road Map issues, it is not only a question of meeting accession requirements for the sake of meeting them. It is a question of implementing policies that bring BiH closer to Europe and at the same time deliver benefits to citizens.

Although there have been some concerns expressed regarding the costs of establishing such agencies, it is clear that regulation of markets in specific areas such as public utilities and banking, etc., is of fundamental importance in the governance of any country. While regulatory regimes are a necessity, they must be designed in accordance with the needs and resources available here in Bosnia and Herzegovina.

The presentations made at the conference may be viewed on the OHR website at: www.oht.int//

3. Banking and Finance

Banking Reform Amendments Go to Parliament

Following seventeen months of intensive drafting efforts involving international organization experts, government banking agency officials and bilateral embassy representatives, a comprehensive set of amendments have been presented to the Federation Government for adoption by the Parliament. The amendments, drafted in an effort to prevent future abuses of depositors' trust such as have occurred in recent years, would put into place major improvements in bank transparency, restrict improper lending practices, introduce new accountability and handling requirements for government revenue funds, and combat money laundering. The draft legislation was submitted to the Federation Government in May and Parliamentary adoption is expected before the summer break.

Recognizing the need for harmonized bank laws as a key component of the process of building a single economic space, the Working Group also provided the draft text to the RS Finance Ministry in February, and a joint Entity Working Group is currently consulting to ensure maximum conformity in the Entities' laws.

As noted in the previous edition of the newsletter, an essential condition for expanding commercial lending –

fundamental for business expansion and job creation, particularly in the critical SME sector – is the establishment of a legal framework in which both lenders and borrowers' rights are clearly delineated and widely respected. In this regard, intensive efforts are underway to develop such relevant legislation as laws on bankruptcy, registered pledges, and obligations (contracts), with final drafts anticipated in the next few months. These laws will form important components of the broader effort to improve the business environment and stimulate economic growth and investment.

4. Telecommunications

Despite the absence of a modern legal framework, the Communications Regulatory Agency (CRA) has continued its efforts to establish a pro-competitive regulatory regime for all market participants in the telecom sector. On June 4th, the CRA issued licences to the three public fixed line operators (Telekom Srpske, BiH Telecom, HPT Mostar) that allow these operators to provide telecommunications services throughout the entire country. In order to access citizens and businesses in territories that are currently provided by another competitor, each operator is obliged to interconnect its network with those of the competitors. The Rule on Interconnection that entered into force on the same day determines the technical details. Both the licences and the Rule on Interconnection are available on the CRA homepage: www.cra.ba.

With regard to privatization, the Federation Government made a decision at the time of writing that up to 10 percent (or 63.460.420 KM) of the state capital in BiH Telecom would be privatized through the method of public registration of shares during the summer. This follows a decision by the Federal Privatization Agency that 67 percent of the BiH Telecom will be privatized through a tender sale to a strategic investor,

10 percent through the method of public registration of shares and the rest to be retained in the ownership of the Federation. The Government apparently made the same decision for HPT Mostar but the amount of the nominal value has still to be determined because of HPT's incomplete separation of post and telecommunications.

5. Energy Sector

During the past three months the focus has been on the passage of the entity electricity laws. Both draft laws are currently before parliamentary procedures but intensive efforts with IC technical assistance are still needed to harmonize the RS proposal with the state Electricity Law and the RS electricity policy statement. Caused by a lack of political will in both entities the passage is now almost six months behind schedule for the Power III project.

The implementation of the state Electricity Law has been ongoing with regard to the preparation of statutes and institutional arrangements for the Regulatory Commission and the Independent System Operator.

6. Transport

Air Transport

European Commission in BiH representative Hansjörg Kretschmer recently opened the reconstructed control tower at Mostar Airport, a project worth €1.35 million. The control tower will be fully operative by the beginning of next year after EU donates a further €1 million for the necessary equipment. The personnel required for its operation are currently in training in the Czech Republic.

The EC raised concerns over the fact that the two weekly scheduled flights to Mostar from Dublin, have been canceled. This will mean that some 10,000 pilgrims being transported from Dublin to Medjugorje will now use Split or Dubrovnik

airports for their travel arrangements, resulting in a substantial loss in revenues for the Mostar airport.

Rail

After more than a decade, passenger service resumed on June 18 from Banja Luka to Belgrade, via the Republic of Croatia. The train will operate on a daily basis to Belgrade, departing from Banja Luka at 21:50 h, and arriving in Belgrade at 6:27 h, and from Belgrade at 15:30 h, arriving in Banja Luka at 00:48 h.

The general directors of the railways from the region Podunavlje to the Adriatic, decided at a meeting in Plitvice, on June 21, to form a group for cargo traffic. The group will propose joint guidelines for the modernization of the cargo traffic in the region, and the movement of international trains on the East-West line in order to increase the railways' share of passenger transport.

Road Transport

BiH and the World Bank signed a \$30 million development credit on management and safety of roads, approved under International Development Agency (IDA) terms. BiH Foreign Trade Minister Azra Hadziahmetovic and WB Director to BiH Joseph Ingram signed the agreement. The credit will be used in the next five years to improve the road network and will be co-financed by entity governments with an additional KM 23 million. Minister Hadziahmetovic said after the signing that roads and other infrastructure are a basic precondition for economic growth because they create conditions for increasing business activities.

Water Transport

Representatives of Yugoslavia, Croatia and BiH in the sub-group for economic development within the Stability Pact for South-Eastern Europe agreed on the framework for an action

plan for reconstruction and development of traffic on the Sava river. The agreement foresees cooperation in the field of planning of economic development of the river, protection from floods, use and management of water as well as environmental rehabilitation and tourism development.

7. Economic Reform in the RS

How has the RS Government implemented its Economic Strategy?

In March 2001 the RS National Assembly adopted the RS economic strategy that systematizes Republika Srpska's economic reform process. Since the RS Government's mandate is coming to an end, we feel it's the right time to summarize the major plans of the economic strategy and their achievements so far. Overall, most of the anticipated legislative plans have been fulfilled and there has been substantial progress in reform implementation with regard to strict budgetary policy, tax enforcement, treasury implementation and bank privatization. In detail:

Chapter 2, the **Goals for the Year** was discussed in the December edition of the Economic Newsletter. They have been achieved overall (see: www.ohr.int).

Chapter 3 deals with the **Macroeconomic Policy**, sub-divided in monetary issues, tax policy, foreign trade policy, and regional developments. The monetary and fiscal policy includes:

- The Law on Micro-Credit Organizations, the Law on Default Interest Rate, planned changes to the Law on Banks, planned changes to the Law on Banking Agency has been adopted, and further major reforms are being considered;
- The Stock Exchange and the Share Registry have been established;
- The entity Law on Deposit Insurance has been adopted, but lack of eligible banks will lead to the

establishment of a state-level deposit insurance body (currently undergoing parliamentary procedure).

- The Excise and Sales Tax has been harmonized with the Federation and the Brcko District and the implementation of the excise refund mechanism is progressing;
- The Law on Income Tax and the Law on Profit Tax have been adopted which reduce and harmonize tax rates and expand the basis;
- The social contributions have been simplified and reduced according to the adopted Law on Contributions with a view to give more incentive for official labor contracts;
- The Government has strengthened financial discipline significantly (also via implementing a treasury system, reduced subsidies to loss making companies, and tax enforcement measures);
- The Draft Law on the Budget System systematizes the financial relations between municipalities and the RS; (awaiting 2nd reading of the law).

The RSNA has adopted the Law on Foreign Investment and the Law on Concessions and the RS Government has actively participated in the Stability Pact discussions (within the BiH delegation). The RS regional policy has been focused on a clear definition of criteria for municipal development as adopted.

The chapter 4, **Microeconomic Policy** focuses on privatization:

- The speed of company privatization has been recently increased, but not for strategic companies. The overall slow pace of the privatization process is still a major concern.
- Nearly all banks have been privatized or prepared for liquidation within the past year and a half. Politically motivated loans to loss-making companies have been significantly reduced.
- The Law on Privatization of Apartments has been adopted

and roughly 20% of the apartments have been sold.

Chapter 5 declares goals for the following **Sector Policies**: agriculture, infrastructure and natural resources. We consider the agricultural policy's results to be modest and see major achievements in the infrastructure policy as follows:

- The Law on Railways, the Law on Roads, the Law on Internal Waterways, and Amendments to the Law on Post Offices have been adopted. The electric power industry increased its efficiency;
- The draft versions of the Electricity Law, the Law on Civil Aviation and Gas Sector Law have been adopted by the RSNA, awaiting second reading.

Chapter 6, **Social Policy and Investments in Human Resources** deals with the care of socially vulnerable groups, the reform of the pension and health insurance system, and education reform.

- The Law on Child Care, the Law on Amendments to the Law on Pension-Invalid Insurance, the Law on Health Chamber, the Law on Safety and Inspection of Groceries and Objects in General Use, and the Law on Changes and Amendments to the Law on Sanitary Inspections have been adopted;
- A Program for Social Care and Transformation identifies vulnerable persons and regulates certain subsidies, but a reform of the Health Insurance Fund including its funding and plans for a social program to accompany privatization have not achieved concrete results to date.

Chapter 7 deals with **Public Departments, Authorities and Battle against Corruption**.

Legislative reform and efforts concerning the internal organization of the Government are ongoing. Fighting corruption has reached initial results with the adoption of

the Law on Money Laundering. However, a Law on Corruption was withdrawn from the agenda.

8. Privatization

General

The privatization process during the last quarter has been rather uneven in the two Entities and Brcko. Noticeable is the acceleration of the results in the strategic group of FBiH companies and a relative stagnation of results in the large scale group, whereas in the RS the trend is the reverse with no new strategic enterprise sold during the last quarter but an encouraging result in the large scale group. In Brcko, the first company has finally been successfully sold which is hopefully a good omen for the District's own privatization program. Generally speaking, it should be recognized that attracting foreign investors to take financial risks in BiH is difficult under the circumstances prevailing in the country and even more so in a pre-electoral period.

FBiH

With 6 new strategic companies sold in the past semester, bringing the total to 13 firms successfully privatised, the results can be considered as promising. Another 10 companies in this category are expected to be sold by the end of the year. Such a result would be in line with the anticipated 40% of strategic companies transferred from the public to the private sector by yearend 2002. During the month of May, the Privatisation Technical Assistance Credit (PTAC), a mechanism proposed by the WB was accepted by the Parliament and is now operational. The WB experts assigned to strategic companies will finally start their work and one of the first companies prepared by the WB may be privatized toward the end of this year.

A new aspect in the privatization of large companies is the increased number of purchases through Management Buy-Out (MBO)

or Employees Buy-Out (EBO). In the absence of committed strategic partners this trend is definitely a positive sign of confidence in the future of the offered companies by the people most directly concerned. The third phase of Public Offering of Shares (POS) for voucher holders will start on the 22nd of July and last for one month. As most of the readers of this newsletter are aware, this POS like the two preceding offerings, relates to the sale of 33% of the capital of the companies concerned.

In the small scale privatization segment, 214 companies out of a total of 322 (66%) have been sold up to the end of June, slightly above the expectations highlighted in previous editions of our newsletter.

RS

The sale of strategic enterprises in the RS is stagnant and this is preoccupying the IC representatives. The number of successful sales so far is still at 4 companies, a result far below expectations. The reasons are diverse but the most important ones are the weak economic perspectives of the Entity as well as the lack of dynamism and means of the privatization authorities for this segment of privatization.

The RS National Assembly has recently adopted a new Law on Writing off Claims. This concerns mainly companies' liabilities that have little chance of being re-paid and constitute a heavy burden for already heavily indebted firms. By allowing this selective possibility of disposing of old liabilities, the RS would intend to give a boost to the privatization process by streamlining the Opening Balance Sheets of the enterprises concerned.

As mentioned above, the privatization results are slightly better in the large scale group with 154 out of a total of 648 (24%) companies fully sold up to now. As for the small scale companies, the privatization pace has been maintained with a

total of 43% having been sold by the end of June, mostly for cash and Frozen Foreign Currency Savings (FFCS).

The attention of the RS Govt. has been drawn to the slow progress of privatization and additional support to the DfP been promised by the Prime Minister in terms of qualified personnel and new premises.

Brcko

The special status awarded to the Brcko District (BD) concerns the privatization process as well. To harmonize the privatization between Brcko and the two Entities has been a constant preoccupation for some time in order to avoid protracted processes due to disputes. In particular, the fact that 55% of the capital of some Brcko companies was offered in the RS through certificates last year created major problems when the BD offered the same companies to be sold against certificates or vouchers for only 33% of their capital, such as is the case in the FbiH. In order to advance in the process and not delay further before starting privatizing, the BD companies are now being offered for cash first and a mechanism called "Minority Share Fund" has been designed and put in place by OHR to manage the 33% portion of capital reserved for voucher/certificate holders. The compensation (22%) of the RS citizens concerned is not envisaged at this stage.

The contract for the first company privatization in Brcko has been signed end of June: Bimal Vegetable Oil Mill was successfully sold to an Austrian enterprise, Seed Oil Holdings.

9. Social Sector

BiH Pension System

Currently, there are two Pension Funds in BiH, one in each of the Entities. As the official economy in the entire BiH is

growing at a relatively slow rate, with official rates of unemployment hovering around 40%, hope of improving the financial situation of pensioners remains low. The average pension in the Federation is KM 190, whereas in the RS it is only KM 120. The Federation Fund has accumulated 3.3 months' arrears from the year 2000, while the RS has 4.5 arrears from the same year and is one month behind in paying the current year pensions. New arrearages should not occur as long the HR Decision imposing a rationing mechanism is implemented regularly by rationing pensions in accordance with available funding in the form of collected contribution payments.

How can the pension systems in BiH be improved? Only through growth of the official economy can the systems be financially strengthened. Pension payments come from the direct payments into the funds in terms of pension contributions by employees. Economic growth and better enforcement mechanisms aimed at expanding the number of contribution payers are essential to increase the inflows into the Pension Funds. Furthermore, the creation of a single economic space in BiH will lower the economic disparity between the Entities and thereby the financial disparity between the two Pension Funds. Once the financial positions of the two Pension Funds begin to converge, it will be possible to consider the creation of a single pension fund for the entire country. The benefits of such reform would be significant: returns would be facilitated by equalizing pension levels across the Entities, and cost-effectiveness would be improved by downsizing the pension administration.

10. Taxation Issues

TAX POLICY AND ADMINISTRATION

FBiH Tax Administration Law

Following a prolonged effort the FBiH has a new Tax Administration Law which was passed on 4 June 2002, resulting

in large part from active support by Prime Minister Behmen and Deputy Minister of Finance Hafizovic and their close cooperation with the International Advisory Group – Taxation (IAG-T) and the International Community.

Rule books to allow this law to be implemented are in the process of being finalised.

The new law provides necessary powers to the FBiH Tax Administration (similar to those that already exist in the RS and Brcko) to establish a specialised large taxpayers and investigations unit. The law also considerably speeds up the resolution of tax disputes and should facilitate speedier collections of outstanding tax debts.

Tax Issues Arising out of OHR Economic Department Cantonal Visits

In view of a great deal of attention being focused upon the FBiH Cantons' budgets, OHR Economic Advisors conducted visits to all of the ten Cantons over a three month period. Discussions were usually held with Cantonal Ministers of Finance and Heads of Cantonal Tax Offices.

A few common themes with regard to taxation emerged, including the collection point of sales tax on excisable goods (cigarettes, alcohol etc) to their point of production / import, as opposed to their place of final sale due to the high level of sales tax evasion. Concerns were expressed about the setting of the rates of the sales tax and wage tax (set at the FBiH parliamentary / governmental level), while these taxes are the revenue sources of the Cantons. Since 2000, the wage tax has been cut from 15% to 5% and sales tax rates reduced from 24% to 20% (higher rate) and 12% to 10% (lower rate).

Excise Allocation Mechanism

On 8 July 2002, the inter entity / Brcko District Excise

Allocation Mechanism was signed and at the time of writing, is set to become effective from 15 July 2002. A joint effort by the World Bank and CAFAO with OHR support, a major condition for the PFSAC II credit (third tranche) to be advanced has been met by the introduction of this excise mechanism.

Correct implementation of this mechanism should provide for excise tax to be paid only once (albeit by the use of a credit mechanism) in the entity / fiscal jurisdiction where excisable products are consumed.

One less welcome side effect of the mechanism is that it will for the first time, formally require different invoicing procedures to be adopted when conducting inter entity trade and consequently will highlight the existence of three single economic spaces inside BiH.

IAG-T VAT position paper

The International Advisory Group-Taxation (IAG-T), issued its VAT position paper for the consideration of the ETF. The IAG-T position is a majority position which recommends from the tax jurisdiction point of view that the whole of BiH is the same jurisdiction. This means that VAT should operate in the same manner for both same entity and inter entity transactions and business.

GTZ Income Tax Microsimulation in Brcko

GTZ have made available the results of their microsimulation exercise in Brcko. Briefly, this involves processing of microeconomic data available in the Brcko district including tax revenues received from their existing corporate, wage and personal income tax and attempting to determine the tax rates and allowances for the new proposed combined corporate and personal income tax law.

Particular attention has been paid to determine the appropriate rate of personal income tax to ensure there are no

revenues losses / leakages should the system be changed with effect from 1 January 2003.

11. Budgets

The State Government / BiH State Institutions budget was finally passed on 30 May 2002. This budget was passed under urgent conditions with significant attention coming from the International Community. If the State Budget had not been passed, an extremely important IMF precondition for the IMF Board to consider the BiH Standby Agreement would not have been met. The absence of the IMF Standby would mean that a whole range of bilateral credits and donations would not be available to BiH.

The BiH State Budget is by its nature a bizarre animal. Hence, OHR Economic Advisors Sandrine Petroni and Vedad Ramljak have created a visual presentation* that aims to illustrate the main features of BiH budgetary structure as well as BiH authorities' fund flows. From the analysis of BiH budgetary data it thus reveals that around 60% of the total amount budgeted for BiH state institutions (KM 292.4 million out of KM 492 million) is allocated to debt repayment. This represents the debt repayment of the entities that provide the vast majority of the State Budget's revenues. The State government itself has very few "own revenue" sources (fees, certain charges) and does minimal taxation powers. Out of the approximately KM 200 million available to the State Budget (after debt repayment), just under 25% is derived from the State's own revenue sources.

Click [here to access the Capital Flows in BiH presentation](#) .

Click [here to see comments on the presentation.](#)

Click [here to see the Presentation Key.](#)

12. Agriculture Sector

AGRICULTURE AND RURAL CREDITS

Ready access to financing is a missing link in the development of the agricultural sector. Perceived high risk factors have prevented lenders from providing the needed loans to boost the post-war restart of this critical sector.

To improve this situation the European Commission recently initiated a rural credit programme with a grant estimated at up to a maximum of 5 million Euros to establish Rural Credit Facilities in BiH. The available amount per project will be 5.000 – 100.000 KM and interest rates will be on a commercial level. This project, “Seed Capital and Credit Facilities” has various beneficiaries such as returnees and internal displaced persons, farmers, agro processing companies, farmer’s associations and co-operatives (i. e., machinery rings). The project also involves local banking institutes.

To obtain regular credit interested farmers must do their homework by preparing a sound business plan for their agricultural project. For this phase assistance is also available, for example through the 16 extension centres all over BiH. Having written a business plan farmers or cooperatives can apply at the following institutes: Raiffeisen (primarily for rural enterprises and cooperatives), MEB Micro Enterprise Bank or one of the following Microcredit Organisations: EKI, SINERGIJA and Microfin.

It is important to inform farmers about these opportunities now and to encourage them in entrepreneurial activities. Many sector observers consider the current interest rates for agricultural projects to be overcautious and it should be possible to develop good projects at regular interest rates.

13. BiH Economic Data January 2001 – May 2002

Source: FBiH and RS Statistical Offices

Indicator	Federation of BiH	Republika Srpska	BIH (OHR estimate)
GDP nominal 2000 GDP nominal 1999 Nominal increase 1999-2000 Real increase 1999-2000 (minus inflation)	6,698 billion KM 6,141 billion KM + 9,0% +7,8%	2,463 billion KM 2,180 billion KM + 13,0% -0,6%	9,161 billion KM 8,321 billion KM +10,0% +5,5%
Index of Industrial Production 05/02 compared to 2001 05/02 compared to 03/01	+4,0% +0,1%	-16,8% -17,2%	N/A N/A
Retail Price Index 05/02 compared to 2001 05/02 compared to 05/01	+0,2% -0,2%	+1,6% +2,7%	N/A N/A
Average Net Salary 04/02 03/02 compared to 2001 (averages)	475,34 KM +7,2%	349 KM +11,5%	429 KM N/A
Number of Employed 04/02 (RS 09/01) Number of Registered Unemployed 02/02 (RS 05/02)	390.736 persons 277.740 persons	219.954 persons 144.918 persons	610.690 persons 422.658 persons
Number of pensioners in 05/02 Average pension in 05/02 (RS 04/02)	287.840 persons 190 KM	181.785 persons 120,03 KM	469.625 persons 165 KM

Imports Jan-Feb 02	1,128	0,640	1.768
Exports Jan-Feb 02	billion KM	billion KM	billion KM
Trade deficit Jan-Feb 02	0,309	0,169	0.478
	billion KM	billion KM	billion KM
Import/Export coverage	0,819	0,471	1.290
	billion KM	billion KM	billion KM
	27,4%	26%	27%

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